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ELY - Q3 2016 Callaway Golf Co Earnings Call

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OVERVIEW:

Co. reported 3Q16 consolidated net sales of $187.9m, net loss of $5.9m and net loss per share of $0.06. Expects full-year 2016 net sales to be $870-880m and fully-diluted EPS to be $0.50-0.54.

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PRESENTATION

Operator

Good afternoon. My name is Doris and I will be a conference operator today. At this time I would like to welcome everyone to the Callaway Golf third-quarter earnings conference call.

(Operator Instructions)

I will now turn the call over to our host Mr. Patrick Burke, head of Investor Relations. Sir, please go ahead.

Patrick Burke - *Callaway Golf Company - Head of IR*

Thank you, Doris, and good afternoon everyone. Welcome to Callaway's third-quarter 2016 earnings conference call.

I'm Patrick Burke, the Company's head of Investor Relations. Joining me on today's call are Chip Brewer, our President and Chief Executive Officer, and Robert Julian, our Chief Financial Officer.

Any comments made during the call about future performance, events, prospects or circumstances including statements relating to estimated 2016 net sales, gross margins, operating expenses, pre-tax income, taxes and earnings per share, future industry or market conditions, the success of the Company's 2017 product line or other future products, future profitability, growth or performance, the creation of long-term shareholder value, the collectability of accounts receivable and salability of inventory, estimated 2016 capital expenditures and depreciation and amortization expenses, future investments, initiatives or corporate development opportunities, reversal of the Company's deferred tax valuation allowance, future tax rate and the ability to use the net operating loss carryforwards as well as other statements referring to future periods and identified by words such as believe, will, could, would, expect or anticipate are forward-looking statements subject to Safe Harbor protections under the federal securities laws. Such statements reflect our best judgment today based on current market trends and conditions.

Actual results could differ materially from those projected in the forward-looking statements as a result of changes to or risks and uncertainties inherent in the Company's business or factors affecting the Company's business. For details concerning these and other risks and uncertainties you should consult our earnings release issued today as well as Part I Item 1A of our most recent Form 10-K for the year ended December 31, 2015 filed with the SEC together with Company's other reports subsequently filed with the SEC from time to time. Also during the call in order to provide a better understanding of the Company's underlying operational performance we will provide certain of the Company's results and projections on a constant currency basis, which essentially excludes all foreign currency gains and losses recorded during the applicable period and applies to prior-period exchange rates to the adjusted current or future period financial information as though such prior-period rates were in effect during the current or future period.

We will also provide information on the Company's earnings excluding interest taxes and depreciation and amortization expenses and excluding the gains or proceeds from the sale of a portion of the Company's TopGolf investment. This information may include non-GAAP financial measures within the meaning of Regulation G. The information provided on the call today and the earnings release and related schedules we issue today include a reconciliation of such non-GAAP financial information to the most directly comparable financial information prepared in accordance with GAAP. The earnings release and related schedules are available on the investor relations section of the Company's website at www.callawaygolf.com.

I would now like to turn the call over to Chip.

Chip Brewer - *Callaway Golf Company - President & CEO*

Thanks, Patrick. Good afternoon everyone and thank you for joining us for today's call. Q3 2016 was another strong quarter for our Company.

We continue to be pleased with our operating performance and as a result we are raising our guidance for the year. Our long-term strategy is to continue to improve our core business while also strategically developing profitable growth in tangential areas. We believe we are tracking well against and this strategy and that it will deliver long-term shareholder value.

Let's start by taking a deeper look into our operational performance for the quarter. In the US our revenues were up 6.9% despite soft market conditions including the bankruptcy of Golfsmith. This performance was driven by excellent marketshare performance. Our year-to-date hard goods marketshare through Q3 was 22.7%, up 140 basis points year over year and growth in both green grass distribution and custom product.

We both sustained our leadership position in the clubs business with 25.7% share year to date, up 120 basis points, and strengthened our brand momentum and position in golf ball with 13.7% year-to-date share up 220 basis points. We also delivered this performance despite fewer product launches in Q3 year over year. The key product that was launched was the Steelhead irons for which feedback and market performance have been outstanding.

We are very pleased with and proud of US business performance over the last several years. This business is now strong and well-positioned.

Market conditions in Asia were challenging and our Japan business delivered a mixed performance during the quarter. On the positive side our new Japan apparel JV got off to a good start and is on track to provide long-term growth. For the quarter it provided $11.5 million in revenue, approximately $9.6 million of which was incremental after consideration of product transfers from Callaway to the JV.

Turning to the core Callaway Japan business, our revenues there were down approximately 20% on a constant currency basis, reflecting both less new product launches year over year and soft market conditions. Although this is a significant decrease for the quarter, it is mostly related to timing of launches. For example, in local currency Q2 revenues in Japan were up 25%, Q3 revenues were down 20% and Q4 revenues are anticipated to be up nicely.

Despite the big swings we are roughly on track relative to our revenue forecast for the full year with a meaningful improvement in earnings. Furthermore, I'll hard goods marketshare improve during the quarter to 15.9% and is now down only 20 basis points year over year. Looking forward in this region we are anticipating continued soft conditions for the balance of this year but most importantly we believe we remain well-positioned to deliver long-term growth thanks to the combination of our core business operating performance, currency trends and our apparel JV.

Turning to Europe, our business there had an excellent quarter with constant currency revenues up 6.1% and marketshare continuing to improve. Our pan-European hard goods marketshare through August was 21.8%, up 80 basis points year over year and we remain the number one brand in that market.

As of now we have not seen any meaningful impact from Brexit other than the sharp drop in the British pound. We will continue to monitor this going forward but for now I'm encouraged both by the resilience of these markets, Datatech Reports that the total market is up year to date in Europe and the steady improvement that the European team has delivered. I believe Callaway Europe is building on its strengths and is in a strong competitive position going forward.

Turning to the product front, our 2016 product range is performing at or above expectations in nearly every category. Our golf ball business grew an impressive 11.6% during the quarter. Our irons and wedge business grew 18.4% during the quarter led by hours Steelhead launch.

In September our US share for irons was 32% and is 27% year to date, thus building on our leadership position in the iron category, a position built on brand equity and powered by our cup face 360 technology. In addition, our 2017 product range is shaping up a beautifully. I believe it will be one of the strongest ranges I have ever been part of.

Moving to strategy, continuously improving our core business has been the keystone of our strategy here at Callaway Golf and we believe we have delivered nicely against this goal. For example, on a year-to-date basis our revenue is up 2.5% this year, our gross margin is up 110 basis points, our operating income is up 8.2% and our cash or liquidity position is extremely strong. These results have allowed us to move into the second stage of our strategy, one which includes continuing to focus on improvements in underlying operations but also engage in strategic investment opportunities both within our core business and in tangential areas.

To date there have been three good examples of this. First is the new apparel JV in Japan. This provides a clear growth opportunity in a related space.

Second is the purchase of Toulon Design and the hiring of Sean Toulon to run our global putter business. This strengthens our management team and provides a growth platform in the premium putter category.

And third, today's announcement of the hiring of Rock Ishii, former senior director of golf ball innovation at Nike. This reflects incremental investment in basic research and new product development in the increasingly important golf ball category.

At a time where other companies are either exiting the hard goods space or being forced to cut back on investments we believe our ability and commitment to reinvest will differentiate us and deliver profitable growth in the future when market conditions inevitably improve. I believe history is full of examples that show that those that invest during difficult times are often the ones that do the best in the long run. Looking forward, we expect continued mixed market conditions through the balance of this year, but we believe our operating performance will outweigh these conditions and thus we are raising both our revenue and EPS guidance.

In closing I'm pleased with our year-to-date performance and I believe that we are on track with our plan to create long-term shareholder value. Robert, over to you.

Robert Julian - *Callaway Golf Company - CFO*

Thank you, Chip. Today we are reporting consolidated Q3 2016 net sales of $187.9 million compared to $175.8 million in Q3 2015, an increase of 6.9%.

The $12.1 million increase is attributable to the Japan apparel joint venture, some foreign currency favorability and the success of our 2016 product lineup led by both irons and wedges, which group 18.4%, and golf ball which grew by 11.6%. The Company also continued to see improved average selling prices across multiple product categories.

Gross margin was 42.0% in Q3 2016 compared to 44.1% in the prior year, a decrease of 210 basis points. This decrease was driven by a shift in product launch timing and compensation as we experienced unfavorable mix and higher compensation expense during the quarter in support of new product launches in Japan and the US. This was partially offset by higher average selling prices and higher golf ball margins in Q3 2016. Year to date, gross margins continue to show improvement over last year, increasing 110 basis points to 45.5%.

Operating expense was $84.1 million in Q3 2016, a 9.5% increase compared to 2015. This increase was primarily due to expenses associated with the startup of the Japan apparel joint venture, some incremental bad debt expense associated with the Golfsmith Golf Town bankruptcy and the timing of marketing expenses as we have made a conscious decision to shift marketing expenditures from Q1 and Q4 into Q2 and Q3. Operating expense as a percent of revenue was 44.8% in Q3 2016 compared to 43.7% in prior year.

As a result of higher sales and gross profits offset by higher operating expenses, pre-tax loss was $4.4 million in Q3 2016 compared to a pre-tax loss of $2.1 million in Q3 2015. Other income was $820,000 in Q3 2016 compared to other expense of $2.8 million in the prior year. This improvement was the result of lower net interest expense related to the conversion of our convertible notes in 2015 and a slight benefit from foreign currency.

The Company generated net loss of $5.9 million in Q3 2016 compared to a net loss of $3.6 million in Q3 2015. Earnings per share decline to negative $0.06 on 94 million shares in Q3 2016 compared to negative $0.04 on 84 million shares in Q3 2015.

Now turning to the balance sheet, we ended Q3 2016 with cash of $125 million compared to $42 million for Q3 of 2015, a 200% increase. Regarding our asset-based credit facilities we had no borrowings at the end of Q3 2016 which is consistent with the end of Q3 2015. Available liquidity as of the end of the quarter including cash improved to $222 million, an increase of 50% versus prior year.

Our consolidated net accounts receivable were $158 million at the end of Q3 2016, an increase of 3% compared to 2015. However, DSOs decreased to 77 days compared to 80 days last year. We remain comfortable with the overall quality of our accounts receivable at this time.

During Q3 Golfsmith International, the owner of Golf Town and Golfsmith retail outlets, filed for bankruptcy protection. Prior to their announcement we had carefully managed our net exposure to Golfsmith and Golf Town which are both significant customers in the off-course specialty channel and we expect to be able to collect substantially all of the outstanding accounts receivable balance owed by Golfsmith and Golf Town either through the bankruptcy process or through our trade credit insurance.

Our inventory balance decreased by 15% to $157 million at the end of Q3 2016 compared to $185 million for Q3 2015 driven by improvements in our sales and operations planning process and by the strategic decision to extend product life cycles in woods and irons. The decline in our inventory balance is particularly notable given the inclusion of the Japan apparel joint venture inventory into Q3 figures.

Excluding the inventory from the Japan apparel JV, our inventory balance decreased by 19.5%. We remain comfortable with the quality of our inventory at this time. Capital expenditures for Q3 2016 were $4.7 million compared to $2.6 million in Q3 2015 consistent with our expectations. Depreciation and amortization expense was $4.2 million in Q3 2016, flat compared to Q3 2015.

Our trailing 12-months EBITDA increased 59% to $60.1 million including the TopGolf gain. Excluding the TopGolf gain our trailing 12-month EBITDA increased 12% to $42.5 million. On a year-to-date basis the Company has repurchased 572,000 shares of stock for approximately $5.1 million in cash.

I will now comment on our 2016 guidance. Regarding full-year projections we are raising full-year 2016 guidance. Specifically we estimate net sales to be in the range of $870 million to $880 million, an increase of $26 million to $36 million over 2015.

Full-year 2016 gross margin increases slightly to 44.6%, an improvement of 220 basis points over full-year 2015. Operating expenses are estimated to be approximately $345 million for full-year 2016 and we estimate pre-tax income to be between $54 million and $58 million including the TopGolf gain of $17.7 million.

Our 2016 earnings per share estimate on a fully diluted basis increases to a range of $0.50 to $0.54, up from our previous estimate of $0.40 to $0.50 per share. These figures are based on 95 million shares outstanding and include a tax provision estimate of approximately $6 million and the $0.18 gain on TopGolf.

We estimate our capital expenditures to be approximately $18 million and our depreciation and amortization expense to be approximately $17 million in 2016. The primary drivers of the incremental capital expenditures are related to IT infrastructures and select operations projects including expansion of our custom club capabilities.

Finally, I would like to mention that our current estimates for 2016 do not include any non-cash charges or benefits. For example, it does not include any change in the tax valuation allowance of our deferred tax assets. However, if Callaway continues to demonstrate sustained profitability going forward we expect that this valuation allowance will eventually be reversed.

At that time we will generate a large non-cash income tax benefit. It will also result in an increase to our overall estimated effective tax rate to approximately 38.5% for the period in which the changes made and subsequent periods thereafter. We will conduct our next quarterly evaluation of the Company's deferred tax assets during the fourth quarter.

The determination of when to reverse the valuation allowance and exactly how much to reverse is a long and complex accounting exercise. While we have not completed this exercise for the fourth quarter, our US business has been trending positively and we believe it's reasonably possible that all or a substantial portion of the tax valuation allowance could be reversed by the end of the year. In any case our cash taxes will continue to benefit from our after-tax NOLs of $96 million for some period of time going forward.

That concludes our prepared remarks today. We will now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Randy Konik, Jefferies.

Randy Konik - *Jefferies LLC - Analyst*

Good evening. Thanks a lot, guys. I have a question, I guess first, Chip, can you talk about a little bit more color on the mixed market commentary?

Just give us some holistic commentary on how you are thinking about the US versus Europe versus Asian markets right now. Thanks. That's my first question.

Chip Brewer - *Callaway Golf Company - President & CEO*

Okay, sure, Randy. The US market has been a more challenging market this year.

According to Datatech it's down mid to high single digits and it's obviously suffered from some relatively significant one-time events with bankruptcies with Sports Authority and Golfsmith. Sports Authority was not a significant customer of Callaway, but Golfsmith was a major player in the golf space, so an interesting year that we're experiencing in the US and makes our operating performance all that more impressive in my opinion.

The European market is doing well this year. It's up a little bit and the Asia markets all vary a little. Japan is down but down 1%, 2% this year. So fairly stable markets with the US going through a transition period it appears as the golf industry evolves.

Randy Konik - *Jefferies LLC - Analyst*

Got it. So that leads to I guess my next question.

So if you think about the long-term golf course closure trend we've been seeing over say the last decade and then some of these accelerated sporting chains or golf chain items that we've seen across Sports Authority and Golfsmith, I guess from your seat how do you think about where we are in the innings of from an over distribution or too much real estate dedicated to the stores channel versus the green grass channel? And then how do you think about long-term distribution in your business around green grass and not green grass across the sticks and balls category?

Chip Brewer - *Callaway Golf Company - President & CEO*

Well, green grass is becoming more important to us and you've seen us grow our green grass presence significantly. So that's been an area of double-digit growth and strong performance for Callaway over the last several years and that trend has continued.

There is a rationalization going on in the industry where there was some excess capacity both on the supplier side and the resale side that is cleansing itself now. And so although that's a painful process we are optimistic that that will leave us in a stronger, more sustainable, financially sound position going forward.

And you've seen it in multiple ways. You've seen it in some of the exits to the space. You've seen it in inventories decreasing considerably out in the field over the last several years.

And I can't really call where we are in terms of innings or percentages of that, although I do think we are well along that path. And are we through it? I don't know.

Are we mostly through it? I would hope we are, but that's a difficult read at this point. Clearly we have to be well on that path and one would expect it to abate in the near future.

Randy Konik - *Jefferies LLC - Analyst*

Got it. I guess my last question is with the addition of key personnel in the putter business and the golf ball business over the last few months here, why don't you give us a little perspective on what you hope to bring with that added personnel to this particular category?

Should we expect even more growth into this premium putter area? Should we expect more lines of premium golf balls? I'm just trying to get a sense of what you expect out of these additional key executives in the business. Thanks.

Chip Brewer - *Callaway Golf Company - President & CEO*

Randy, it you should expect a healthier, stronger, more long-term favorable Callaway golf business. These are not short-term investments. You won't see anything meaningful over the next quarter or maybe even the next several quarters.

But a few years ago we put incremental investment into an advanced research group here and we are going to be launching some product in the very near future that came out of at least a portion of that type of investment. Golf ball is an increasingly important category for Callaway and we are really proud of our team and what they have done there and what we are delivering. And I look at the changes of what's going on in the marketplace right now and it's creating an opportunity.

While others are pulling back we have the strength and commitment and focus to reinvest. So the Rock Ishii investment will be additive to existing strong team. I think he's a uniquely strong talent and we are hopeful that at some point in the future we'll deliver more products like Chrome Soft that are uniquely differentiated and resonate.

Sean Toulon is a unique talent as well in the industry. He is a seasoned executive. He will strengthen our management team.

He will add guidance to the putter business. And, yes, Toulon Design will provide the potential to grow the premium putter category. So we are excited about these types of initiatives we are able to find and although there won't be any near-term impact we do think they are going to create long-term value for us.

Randy Konik - *Jefferies LLC - Analyst*

Great, that's very helpful. Thank you.

Operator

Dave King, ROTH Capital Partners.

Dave King - *Roth Capital Partners - Analyst*

Thanks, good afternoon everyone. I guess first off, in terms of the revenue this quarter congratulations there. I guess I was curious what drove the upside relative to your expectations, what was the impact from Golfsmith as far as that goes?

Was there any reduction in selling there as a result? And do you expect any more challenges specific to you guys related to that or, obviously, the receivables bounce, it sounds like you feel okay there but in terms of a revenue impact is there anything we should be thinking about going forward from that? Thanks.

Chip Brewer - *Callaway Golf Company - President & CEO*

Yes, thanks, Dave. Golfsmith was a pretty significant headwind. You know Golfsmith, Golf Town was the world's largest specialty retail golf chain and they went bankrupt.

So yes, that has an impact on your business during the quarter and will for the balance of the year. I think that makes our results all that much more impressive, quite frankly. So we worked through that during the quarter and have factored that into our forecast going forward.

Golfsmith, Golf Town Golfsmith was a 109 door chain. It's now going to be 30 doors. Those 30 doors were purchased by Dick's Sporting Goods who's an excellent partner of ours and a great retail operator.

So we are excited about those 30 doors. But there are 79 doors that will be closing or liquidating over the next few months. Golf Town in Canada is going from 55 doors to 47 so there's eight doors there.

This will create a short-term headwind, but on the positive side we are going to see a much more financially secure and viable channel, probably a healthier channel as we work through that process. But near-term, yes, definitely has created some issue for us and really proud of the team's ability to work through it so well.

Dave King - *Roth Capital Partners - Analyst*

Thanks for that. And then in terms of one of your larger competitors exiting the market, at least on the equipment side, I think there's been some market, call it, difference of opinion in terms of what's the impact that's out there.

I guess to what extent do you think that's already reflected in what you are seeing in terms of from, well, probably not necessarily from a sell-through perspective but a sell-in perspective? And then I guess just what are the high-level thoughts in terms of how industry players are reacting or is everyone remaining fairly disciplined as far as that goes?

And then maybe a follow-up to that, forgive the multipart question, but following on some of the recent hires, maybe can you talk about opportunities for further hires along those lines to take advantage of this opportunity and maybe even opportunities for further tour investment? Thank you.

Chip Brewer - *Callaway Golf Company - President & CEO*

Okay, sure. So we're referring to Nike right?

Dave King - *Roth Capital Partners - Analyst*

Yes.

Chip Brewer - *Callaway Golf Company - President & CEO*

Okay great. So Nike is a giant company and, obviously, a very strong company. They've made the decision to exit the hard goods side of golf equipment, so golf clubs and golf balls.

They did not have significant share or volume in those categories, obviously, hence the decision to exit and of the volume they did have not that much of it was in the premium category. But having said that, clearly there is some upside for us here. It's difficult to quantify what that is and we're really not going to try in the face of so many other factors, very dynamic marketplace right now.

We do think it's a positive. We do think that in addition to just that share there's other upsides and potentials that we're excited about taking advantage of. On the ambassador front, from green grass professionals and relationships to perhaps over tour some time, some relationships on tour we think we are likely to benefit from some of that and we are working on that.

There's unique opportunities such as this Rock Ishii individual. Rock is an industry veteran, he has 33 years in the golf space, he's been involved with product in 25 major championships and I think he will add to what is already a strong team here. So we were able to identify, engage and take advantage of that.

Most importantly, I think it's really representative of an overall improving environment where there's been oversupply and too many competitors trying to grow more than markets there and that is resolving itself. The industry is consolidating, there's economies of scale and advantages of focus that we can enjoy and that others are being more rational. And for many years we've wondered if that would ever happen.

And then just to reiterate, as we go through this week clearly demonstrate our ability to operate in that environment as this works itself out. So complicated answer, but as you mentioned a multipronged question that we're sure we're going to be able to take advantage of but it's hard to quantify.

Dave King - *Roth Capital Partners - Analyst*

No, that's fair. And it sounds like everyone so far is remaining fairly disciplined in terms of trying to take advantage of that opportunity is best you can --

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Chip Brewer - *Callaway Golf Company - President & CEO*

The markets are very rational right now. They have been less promotional this year, etc., even though it's challenging conditions. And I believe that the markets are improving structurally, although that process gets bumpy.

Dave King - *Roth Capital Partners - Analyst*

Okay, that's great color. Thank you and good luck with the rest of the year.

Operator

Mike Swartz, SunTrust.

Mike Swartz - *SunTrust Robinson Humphrey - Analyst*

Hey, good evening, guys. I just wanted to dig through the implied fourth-quarter guidance on the top line.

And it looks like some of the revenue looks like may have been a shift between 3Q to 4Q. You did take up the bottom end of the range which I think is pretty impressive given the Golfsmith bankruptcy. But just trying to get a sense of how to think about core or organic growth in the fourth quarter excluding currency, excluding maybe the new JV and then how do you feel about that, I guess, over a longer range of time, maybe looking into 2017 if possible?

Robert Julian - *Callaway Golf Company - CFO*

Yes, Mike this is Robert. You will recall that when we gave guidance at the end of last quarter we had described a fairly even proportion of sales in Q3 and Q4 between in the second half of the year roughly $175 million each quarter.

Now we far exceeded that in Q3 coming in at $188 million. Our second-half projection, if you calculate what's in our full-year and what we achieved in Q3, we are still projecting second half to be, or we are projecting now second half to be higher than we did the last time we provided guidance. But there is a little bit of a shift with the $188 million that we achieved in Q3.

But overall we are still seeing good growth, we will see year-over-year growth in Q4 versus prior year with the implied Q4 forecast in revenue. I'm not going to break out the piece that is the joint venture versus foreign exchange and so on, but overall as you mentioned yourself our overall guidance has increased. So we exceeded Q3, we are projecting higher second-half results than we had previously and we feel like we have good momentum.

Mike Swartz - *SunTrust Robinson Humphrey - Analyst*

Okay, that's helpful. Thanks.

Then just looking at the ball business, I know you've got a tough comp here in the fourth quarter, but thinking about that longer term, I know you've secured some new green grass accounts for this year. Can you maybe give us a view of how that's maybe playing out as we look into 2017? Are there opportunities for even more expansion into that channel?

Chip Brewer - *Callaway Golf Company - President & CEO*

Yes, Mike, the team has done a great job. As the brand has strengthened they've grown their green grass and distribution and our expectation is that we will be able to continue to do that. So we still look at that channel as a growth opportunity for us and we have just really started to really take advantage of that.

Mike Swartz - *SunTrust Robinson Humphrey - Analyst*

And just following up on that, I think you've said it in the past, but could you give us a sense of market share green grass versus maybe off-course?

Chip Brewer - *Callaway Golf Company - President & CEO*

I don't have that right in front of me right now but our overall market share is stronger off-course than green grass but we are strengthening our green grass position, so that's one of the -- we are really strengthening in both categories. Growing our distribution of green grass at double-digit rate faster than our overall business, growing our green grass and business faster than our overall business. But we still do trend stronger at off-course than green grass.

Mike Swartz - *SunTrust Robinson Humphrey - Analyst*

Okay great. That's all for me. Thanks, guys.

Operator

Susan Anderson, FBR Capital Markets.

Susan Anderson - *FBR Capital Markets - Analyst*

Hi, good job on the quarter you guys. I guess I maybe wanted to verify, it sounds like you still think the industry in the US is pretty rational even given the bankruptcies and the liquidation. And I guess just curious if you expect to see any gross margin pressure into fourth quarter as a result of having to compete with liquidations or anything?

Chip Brewer - *Callaway Golf Company - President & CEO*

Susan, yes. I do think that the industry is rational and is structurally improving.

And we've incorporated the potential liquidation into our numbers and projections for the balance of the year. So I don't think it's a significant factor for us, but it will certainly have some impact and what impact that is in the projections.

Susan Anderson - *FBR Capital Markets - Analyst*

Okay, that's helpful. Then I guess as we look out to 2017 with Golfsmith going I think you said from 109 to 30, how should we think about the displacement of those sales and those 80 doors? Do they just go away or do you think that they will be made up elsewhere or how are you thinking about that?

Chip Brewer - *Callaway Golf Company - President & CEO*

Susan, I think it will be a headwind through 2017, a decreasing over time. I think that a good portion of that business will migrate from those closed doors to new homes whether that be at green grass or other specialty retail or sporting goods.

I think that it will take some time for it to migrate sometimes as people find new places to purchases, patterns evolve and such. So it will have some impact and like other things that we've been through our job will be to operate successfully through that. And I am confident we will be able to.

Susan Anderson - *FBR Capital Markets - Analyst*

Got it. And then I guess one question on capital allocation.

It looks like you guys had pretty good cash generation this quarter. Maybe you could just give us an update on what your priorities are for cash going forward.

Chip Brewer - *Callaway Golf Company - President & CEO*

Sure. Yes, we had excellent results as it relates to cash generation. So we're really going to be thoughtful and disciplined on this.

We have a great liquidity position. We have capital to apply as we find the right opportunities and we've a transition now into a position that we can and are active in evaluating opportunities, both in the core and tangential. So as I mentioned we found three opportunities that we have acted upon and I discussed in my comments and we are excited about those prospects.

We anticipate being able to identify other opportunities that will deliver long-term shareholder value, as well. And in some ways I think we might be uniquely well situated in our space for that given both momentum and commitment and capital structure. So I am encouraged what I see there.

And I think that's probably our first focus because I think that has got the highest potential long-term return. But we will also continue to evaluate stock buybacks or dividends at the appropriate time. So normal evaluation process, and you've seen a supply, the resources now within three specific ways.

Susan Anderson - *FBR Capital Markets - Analyst*

Great. Then last one on the longer-term opportunity on the operating margin.

I think maybe you guys had said 7% to 8% before and it looks like you are quickly making your way there. How should we think about the timing of getting there and could it potentially be more than that at some point?

Chip Brewer - *Callaway Golf Company - President & CEO*

You know, Susan, I hope so but it's too soon to get specific on that. The markets have been so dynamic, and the last thing we want to do is get ahead of ourselves on this. We are definitely trending very positively.

We can't pick the endpoint or the timing quite yet but we will continue to see if we can tighten that going forward. I think that right now the most important thing that I can do for you is just focus you on that right trend and we are enjoying that trend at the moment.

Susan Anderson - *FBR Capital Markets - Analyst*

Okay, that's helpful. Thanks so much. Good luck next quarter.

Operator

Rommel Dionisio, Wunderlich Securities.

Rommel Dionisio - *Wunderlich Securities, Inc. - Analyst*

I wonder if you could just comment on the general state of retail inventories as we exit the season here? I know there's a lot of moving parts between Golfsmith and Nike and I wonder if you could just chat through those issues and to what extent overhang might enter into next year, obviously cognizant of the Golfsmith issue? Thanks.

Chip Brewer - *Callaway Golf Company - President & CEO*

I don't think inventory is going to be an issue going into next year. Inventory is down significantly in the field double digit if I remember correctly, and that's been a trend now for almost two years.

The liquidation is going to be an impact but the liquidation should be a short-term impact. They are not going to spend a lot of time on that, so that will likely work itself out in Q4. And I think the industry appears to be either at or trending to a healthy position from an inventory perspective.

Rommel Dionisio - *Wunderlich Securities, Inc. - Analyst*

Okay great. Thanks very much. Congrats on the quarter.

Operator

(Operator Instructions) George Kelly, Imperial Capital.

George Kelly - *Imperial Capital - Analyst*

Hi guys, a couple of questions for you. First starting with TSI, what is the normal seasonality of that business?

Chip Brewer - *Callaway Golf Company - President & CEO*

George, they have two seasons. So they were strong during this second half of the year where they do a sell-in period there and also in the spring. So a little bit more spread than our general hard good business.

George Kelly - *Imperial Capital - Analyst*

So it sounds like it's more evenly spread throughout the year versus your hard good business.

Chip Brewer - *Callaway Golf Company - President & CEO*

That's correct.

George Kelly - *Imperial Capital - Analyst*

Okay. And that business scales, as you put more -- it just has more time as the partnership comes together, what do you expect for profitability? Can you talk at all about the timeline and what it looks like when it ramps up, any kind of help around that?

Robert Julian - *Callaway Golf Company - CFO*

George, this is Robert. I would say that overall that business has very similar bottom-line profit to our golf business.

I do think you get at it a little bit differently. I think the margins might be a little bit lower and the operating expenses a little bit lower. But more or less it's fairly consistent on the very bottom line with the rest of our businesses.

George Kelly - *Imperial Capital - Analyst*

And do you expect to get for it to get there fairly soon?

Robert Julian - *Callaway Golf Company - CFO*

Yes. It's more or less there now excluding some one-time expenses and startup costs and so on but it was a going concern before. This is not a startup in the traditional sense.

TSI has been selling apparel in Japan for a long time as a licensee with the Callaway brand and they had a number of stores already in place. This partnership just gives incentive to both sides to grow the business further, whereas before it might have been a little more uncomfortable for TSI with the possibility of us pulling the brand from them and the license. But they are actually have been running for some time and they are about where --

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Chip Brewer - *Callaway Golf Company - President & CEO*

So the one-times will be gone by the end of this year. 2017 it will be more or less normalized and we will get a little bit of growth from it and it has some growth potential in it. So we are encouraged by start of that business, George.

George Kelly - *Imperial Capital - Analyst*

Great. And then one last question about tour sponsorships. Have you seen with Nike's changes in and others shifting around in the industry have you seen any kind of relaxed -- is it still just as hard as it was before to get top talent or what does that look like?

Chip Brewer - *Callaway Golf Company - President & CEO*

We haven't seen as much of an impact from the Nike exit in that area as I had anticipated. And it's because the contracts that Nike has with tour players are continuing. And so and they can continue in one of two ways.

Either they continue in total and there is very little logo space available. So Nike will have the headwear and all of the apparel and shoes and there will be no logo space available to share or show the world a Callaway investment. Or they are paying, locking up new players in that and that changes the fit, I guess.

So right now it has not been a meaningful change in the marketplace and we will just have to evaluate that going forward. I do think it will create opportunities but at this point very minimal change.

George Kelly - *Imperial Capital - Analyst*

Okay, thanks.

Operator

(Operator Instructions) We have no other questions in the queue at this time.

Chip Brewer - *Callaway Golf Company - President & CEO*

Well, thank you everybody for dialing in and look forward to talking to you early next year.

Operator

Ladies and gentlemen, this does conclude today's conference call. You may now disconnect.